

Investment markets research – Economic note

22 April 2009

Australia's inflation falls, but underlying measures stubbornly high

Data:

March quarter 2009	%/qtr	%/yr	Dec qtr 2008	%/qtr	%/yr
Headline CPI	0.1	2.5	Headline CPI	-0.3	3.7
Underlying inflation*	1.1	4.2	Underlying inflation	0.75	4.4

*Underlying inflation is the average of the trimmed-mean and weighted-median inflation measures

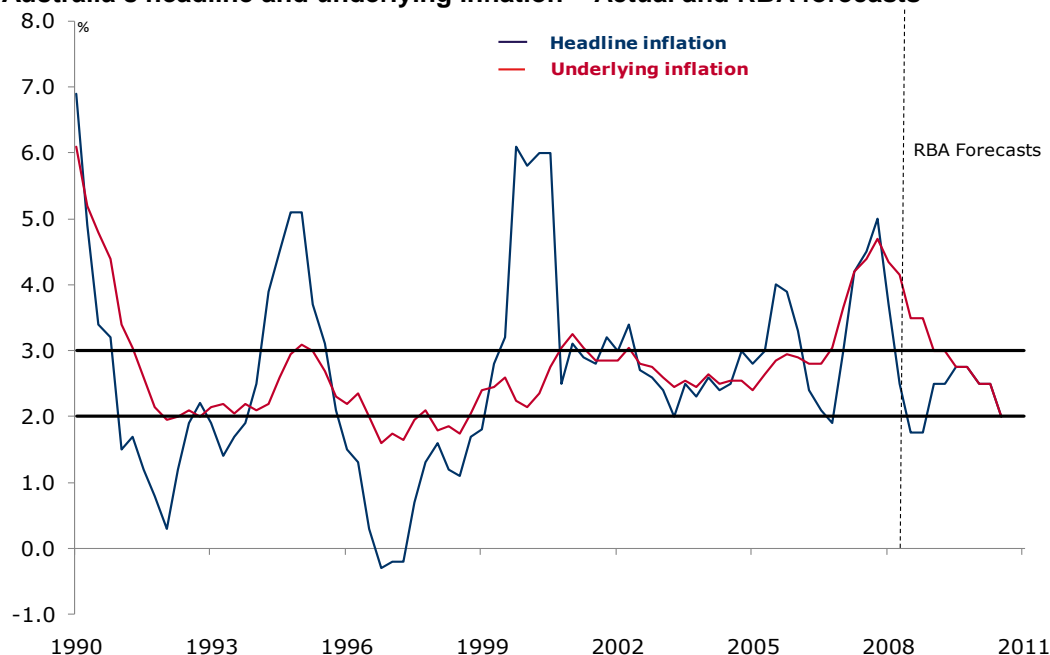
Highlights:

Australia's headline Consumer Price Index (CPI) increased by just 0.1%/qtr in the March quarter 2009, well below market expectations of 0.5%/qtr. This took the annual rate of inflation down to 2.5%, from 3.7% in the year to December quarter 2008. **Australia's headline inflation rate is, therefore, right back into the middle of the Reserve Bank of Australia (RBA) 2%-3% target range, the first time it has been inside the range since late 2007.**

This is good news for the economy and the RBA, as it will provide space for the RBA to continue to ease monetary policy in the months ahead if the economic data deteriorates further. As stated in the Minutes of the April RBA Board meeting (released yesterday) the RBA expects that "as a consequence of the contraction in aggregate demand and output, capacity utilisation had continued to decline and the demand for labour had weakened. Members noted that the staff forecast for growth had been revised lower from that published in the February *Statement on Monetary Policy*. **Inflation over the medium term was expected to continue to decline.**"

However, it should also be noted that the two main measures of underlying inflation, the trimmed-mean and weighted-median¹ rose by a larger-than-expected 1.0%/qtr and 1.2%/qtr, respectively, giving an Underlying inflation increase of 1.1%/qtr. This saw the annual rate of underlying inflation ease only marginally, to 4.2% from 4.4%. This means that away from a few large price declines (see below for details) the underlying inflation rate was stubbornly high at the start of the year.

Australia's headline and underlying inflation – Actual and RBA forecasts



Source: ABS and RBA

¹ The trimmed-mean inflation rate removes the bottom and top 15% items showing the largest price change, so represents the mean of the remaining 70% of all the CPI basket items. The weighted-median is the price change of the middle item, weighted by size/importance.

But, given the generalised weakness in the Australian economy, as highlighted by the RBA Governor, Glenn Stevens, in a speech yesterday where he stated “I think the reasonable person, looking at all the information available now, would come to the conclusion that the Australian economy, too, is in recession”, **it could be expected that Australia’s measures of underlying inflation will also be falling sharply as 2009 progresses.**

Once, however, economy recovery in the global and local economy takes hold, the authorities will be very mindful of the need to remove the extraordinary amount of stimulus that has been pumped into the system, to ensure that the recovery phase from this global recession does not include a return to unacceptably high levels of inflation.

Fortunately, the authorities seem to be very aware of this issue, with the US Federal Reserve Vice-Chairman Donald Kohn, recently stating that “my colleagues and I are acutely aware of the risk of higher inflation as the economic recovery gains speed. We are firmly committed to acting in a way that preserves price stability, and we believe we have the tools to absorb reserves and raise interest rates when needed.”

Some details:

The major contributor to price declines over the March quarter 2009 was a 6.3%/qtr decline in financial and insurance services, with the cost of deposit and loan facilities down a sharp 14.1%/qtr. This represents a decline in interest rate margins for financial institutions as official interest rates have been cut.

Other declines were recorded for transportation costs (-1.5%/qtr), led down by an 8.1%/qtr fall in petrol prices. Recreation costs fell by 1.1%/qtr, due largely to falls in both domestic (-5.1%/qtr) and overseas (-4.0%/qtr) holiday travel and accommodations costs – perhaps as a result of discounting in an attempt to continue to attract holiday-makers in the current economic environment. Prices were also lower for clothing and footwear (-0.5%/qtr).

These price declines were offset by some strong price increases, although some of these are seasonal. Education prices rose 5.4%/qtr, with the start of the new school year seeing the traditional increase in the cost of private education. Health costs rose a solid 4.4%/qtr, led higher by a seasonal increase in pharmaceutical items (+13%/qtr) and hospital and medical services (+2.3%/qtr). In addition, Food prices rose 2.2%/qtr, with a big gain in vegetable prices (+6.0%/qtr), due to adverse weather – floods and bushfires.

On a state by state basis, the largest increase in prices in the March quarter 2009 was in Canberra (+0.4%/qtr), while Perth recorded a decline of 0.1%/qtr and Adelaide was unchanged. All the other major cities recorded price increases of 0.1%-0.2%/qtr.

On an annual basis, Brisbane has the highest inflation rate of 3.1%, with Darwin at 2.8% - perhaps reflecting their past strong economic growth rates supported by the resources boom. The annual inflation rate in the other major capital cities are around 2.1%-2.4%. See table for details.

Capital city	%/qtr	%/yr
Sydney	0.1	2.4
Melbourne	0.2	2.1
Brisbane	0.2	3.1
Adelaide	0.0	2.3
Perth	-0.1	2.2
Hobart	0.2	2.2
Darwin	0.1	2.8
Canberra	0.4	2.7
Weighted average	0.1	2.5

Source: Australian Bureau of Statistics

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